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No. 97-511

Supreme Court, U.S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1997

RHOADES OIL COMPANY

Petitioner,

v.

THE UNITED STATES OF AMERICA

Respondent.

ON A PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

PETITIONER'S REPLY BRIEF

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QUESTION PRESENTED

Did the Tenth Circuit Court of Appeals violate this Court's rulings, reaffirmed most recently in *Commissioner v. Schleier*, 115 S.Ct. 2159 (1995) and *United States v. Burke*, 112 S.Ct. 1867 (1992), that exclusions from gross income are available only if specifically stated and that such exclusions must be narrowly construed, when the Tenth Circuit ruled that the lifting costs of an oil and gas business are excluded from its gross income because such lifting costs are analogous to costs of goods sold which are excluded from the gross income of a manufacturing, merchandising, or mining business under 26 C.F.R. §1.61-3(a)?

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ARGUMENT

The Brief of the United States in Opposition is an exercise in semantics. In its argument, the United States artfully manages to describe how lifting costs are not a part of the gross income of Rhoades Oil without ever using the words "exclude" or "exclusion." Instead, the United States uses "reduction," "reduce," "deducted," "subtracted," "subtract," and "taken into account at the outset." Only when required to quote the language of

the opinion of the Tenth Circuit below does the United States state the obvious - that the opinion below held that lifting costs are "properly excluded" from gross income by analogy to costs of goods sold under 26 C.F.R. §1.61-3(a). In doing so, the Tenth Circuit violated this Court's holdings that exclusions from gross income must be specific and must be narrowly construed. *Commissioner v. Schleier*, 115 S.Ct. 2159, 2163 (1995); *United States v. Burke*, 112 S.Ct. 1867, 1870, 1878 (SOUTER, J. Concurring at 1878) (1992); *Commissioner v. Glenshaw Glass Co.*, 75 S.Ct. 483, 475, 477-78 (1955); *Commissioner v. Jacobson*, 69 S.Ct. 358, 369 (1949).

At its heart, this case comes to a simple question: Should exclusions from gross income be narrowly construed in the rare case when doing so favors the taxpayer? The answer to this question is obvious. This Court's holdings on the construction of exclusions from gross income are the law in all cases, whether favorable to the taxpayer or to the government in any instance.

The argument that the United States is apparently trying to make is that *Schleier*, *Burke*, *Glenshaw Glass Co.*, and *Jacobson* somehow do not govern the issue of whether lifting costs are excluded from the gross income of Rhoades Oil Company because lifting costs aren't really "excluded" from gross income, but are instead "subtracted" from gross income, or are a "reduction" to gross income, or are "to be taken into account at the outset" in computing gross income.

These word games do not distinguish the holdings of this Court. Whether the word used is "exclude," "subtract," "reduce," or "deduct," *Schleier*, *Burke*, *Glenshaw Glass Co.*, and *Jacobson* stand for the principle that everything is in gross income unless there is something specific (which specific thing must be narrowly construed) that takes it out of gross income. And there simply is nothing that takes the lifting costs of an oil and gas produced out of gross income.

Although not directly stated, the United States also appears to suggest, when discussing the underlying rationale of the personal holding company tax provisions, that gross income for personal holding company tax purposes is somehow different than gross income as interpreted in *Schleier*, *Burke*, *Glenshaw Glass Co.*, and *Jacobson*. The penultimate paragraph of the Brief in Opposition states that the issue is "what measure of 'gross income' is most appropriately used" in calculating personal holding company taxes. The flaw in this argument is that there is only one measure of gross income. That measure is 26 U.S.C. §61 and this Court's cases interpreting it.

The inference that gross income is somehow different for personal holding company tax purposes is also directly inconsistent with the main argument of the United States, which relies on the fact that the outdated regulations issued under the personal holding company tax provisions refer to 26 U.S.C. §61 and its regulations for the definition of gross income. Indeed, the entire

argument of the United States hinges on the analogy to 26 C.F.R. §1.61-3(a) made in Revenue Ruling 60-344. That regulation, of course, concerns the definition of gross income under 26 U.S.C. §61, which is the same definition interpreted by this Court in *Glenshaw Glass*, *Jacobson*, *Schleier*, and *Burke* to have been intended by Congress to be as broad and inclusive as possible, with the necessary corollary that exclusions must be specific and must be interpreted as narrowly as possible.

Moreover, the United States fails to point out that the purpose which it claims underlies personal holding company taxes, to discourage abusive use of closely held corporations where income is taxed at lower corporate tax rates instead of higher individual tax rates, was obliterated in 1986 when the highest marginal tax rates for individuals were lowered to be nearly identical to the corporate tax rate. Today, personal holding company taxes are little more than a double tax trap for the unwary. This trap should not be further extended by the analogous extension of 26 C.F.R. §1.61-3(a) made by the Tenth Circuit below.

The argument by the United States that Revenue Ruling 60-344 should be accorded controlling weight as an interpretation by the Internal Revenue Service of its own regulations that is not plainly inconsistent with the language of the regulation is easily exposed. Revenue Ruling 60-344 does not <u>interpret</u> the meaning of 26 C.F.R. §1.61-3(a) at all. Instead, Revenue Ruling 60-344 makes the same mistaken <u>analogy</u> that the Tenth

Circuit did - that lifting costs should be excluded from gross income because they are similar to costs of goods sold which are excluded from gross income under 26 C.F.R. §1.61-3(a). If, as the United States wishes, that analogy is characterized as an interpretation, then that interpretation is in fact plainly inconsistent with the language of 26 C.F.R. §1.61-3(a) because "mining" is not "oil and gas production" and "lifting costs" are not "costs of goods sold." Either way, the argument of the United States does not withstand any degree of scrutiny.

This Court need not decide whether there is, as claimed by the United States, a general rule that costs of goods sold are excluded from gross receipts to determine gross income apart from 26 C.F.R. §1.61-3(a). Even if there is such a rule, it simply does not apply to this case, because lifting costs are not costs of goods sold, as established by the record below. A-69.

RELIEF REQUESTED AND CONCLUSION

Petitioner asks this Court to grant certiorari to correct the Tenth Circuit's error. Exclusions from gross income must be narrowly construed in all cases, not just in cases where to do so favors the government.

Respectfully submitted,

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